

**MASSACHUSETTS DEPARTMENT  
OF  
TELECOMMUNICATIONS AND ENERGY**

<b>Investigation by the Department of Telecommunications and Energy</b>	)	
<b>on its own motion, pursuant to GL. c. 164 §§ 76, 94 and 94A,</b>	)	<b>D.T.E.</b>
		<b>01-100</b>
<b>to investigate the appropriateness of the use of</b>	)	
<b>Risk Management Techniques to Mitigate Natural Gas Price Volatility</b>	)	

**COMMENTS OF DUKE ENERGY TRADING AND MARKETING, L.L.C.**

Gordon J. Smith, Esq.  
JOHN & HENGERER  
1200 17<sup>th</sup> Street, NW  
Suite 600  
Washington, DC 20036  
(202) 429-8814  
gsmith@jhenergy.com

Counsel for Duke Energy Trading and  
Marketing, L.L.C.

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Pursuant to the Massachusetts Department of Telecommunications and Energy's (Department) December 4, 2002 "Order Opening a Notice of Inquiry" (NOI) and the associated Notice in the above-captioned proceeding, Duke Energy Trading and Marketing, L.L.C. (DETM) hereby submits the following comments on Risk Management topics and specific questions set forth in the NOI.<sup>1</sup>

**INTEREST OF DUKE ENERGY TRADING AND MARKETING, L.L.C.**

DETM is a leading national energy marketer with a substantial presence in the New England gas markets, including Massachusetts. In providing natural gas and other energy-related services to its customers, DETM actively employs a number of risk management techniques to minimize the adverse impacts of price volatility upon DETM and its customers. As such, DETM believes it can provide the Department with insight on the topics identified in the NOI, particularly as to how risk management techniques may be applied in the Massachusetts gas markets.

From this perspective, DETM offers the following comments.

**EXECUTIVE SUMMARY**

While risk-management techniques and practices do have certain inherent risks, they can and do provide gas consumers with a number of important benefits, including price certainty, price stability, and the avoidance of short-term price spikes. As explained in more detail below, DETM thus recommends

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<sup>1</sup> On January 14, 2002, the Hearing Officer in this proceeding granted DETM's request for an extension of time (until January 22, 2002) to file its comments.

that the Department permit the Massachusetts LDCs to engage in various risk-management activities, subject to objective parameters determined by the Department with the input of the LDCs and other stakeholders.

### **GENERAL COMMENTS**

The Department is interested in whether Massachusetts gas utilities should incorporate hedging and other risk management techniques into their gas acquisition procedures as a means of mitigating gas price volatility and providing other benefits to gas consumers in Massachusetts. Without hedging, the gas utilities are at the whim of market prices, which can be, and in relatively recent periods have been, very volatile. In a period of low prices, purchases at market are perceived as being beneficial to consumers, while in a period of high prices, purchases at high prices are perceived as being detrimental.<sup>2</sup> Risk management provides a means by which an LDC can minimize the volatility associated with a competitive gas market and achieve a degree of price certainty and stability. LDCs' use of risk management techniques and products should therefore be encouraged by the Department.

The Department should be under no illusion, however, that risk management programs will be either risk free or that they will result in the lowest possible gas costs for consumers. Just as no one can predict precisely the future price of gas, so too no one can hedge "perfectly" if the measure of a "perfect" hedge is that the price of the hedged commodity never exceeds the market price. Accordingly, the Department should approve LDCs' implementation of risk management programs, subject to appropriate parameters, and with a realistic view of what results are achievable under such programs.

DETM makes wide-spread use of risk management techniques as part of its nationwide business of purchasing and selling energy services. Risk management involves consideration of many different

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<sup>2</sup> In fact, one could nevertheless argue that some degree of price volatility is an inevitable and positive characteristic of mature, fully-competitive markets and certainly is preferable to either a period of extremely-low prices, which tends to discourage the production of adequate gas supplies, or a period of extremely-high prices, which tends to discourage economic growth.

factors, including gas supply availability, end-use demand, weather patterns, historical pricing trends, future price forecasts, storage levels and availability, and a number of other factors. The analysis of these many factors to develop a successful risk management program challenges some to the best minds in the business.

Since risk management has inherent risks and costs, DETM suggests that the Department consider a gradual implementation of risk management programs, with LDCs initially being able to hedge only part of their gas portfolios. As experience is gained both by the Department and the LDCs, these programs could be expanded in an appropriate manner. In addition, given the current inexperience of Massachusetts LDCs in the use of risk management products, the Department should consider permitting Massachusetts utilities to link with veteran traders/buyers with experience in hedging techniques and practices. DETM itself would be willing to undertake such a service with and on behalf of Massachusetts gas utilities, on commercially-acceptable terms. Moreover, DETM would welcome the opportunity to make an informational presentation to the Department with respect to risk management products and activities, and related energy services, if the Department would find it useful.

### **COMMENTS ON SPECIFIC QUESTIONS**

The Department posed nine (9) specific questions with respect to the NOI. DETM's responses to those questions are set forth below. These responses are supplemental to and derivative of the General Comments provided above.

1. *Should Massachusetts gas utilities be allowed or required to implement a risk-management program to mitigate price volatility for gas consumers?*

As noted above, risk-management or hedging techniques can be valuable price mitigation tools. DETM, therefore, would encourage their use by Massachusetts gas utilities. DETM recommends, however, that participation in such programs be voluntary and that, so long as LDCs continue to be subject to traditional regulation, they be assured of recovering the costs and losses associated with the

implementation of such programs as they are with any other prudently-incurred costs. Otherwise, LDCs will be discouraged from the implementation of such programs, which can produce significant economic benefits to consumers.

2. *How will risk-management by LDCs affect gas unbundling and customer choice in Massachusetts?*

Gas unbundling gives customers the ability to choose their gas supplier, including use of the franchise LDC. Presumably allowing the LDCs to engage in hedging would place them on a par, in terms of gas procurement practices, with other potential gas suppliers, and should provide the LDCs with a means of offering its sales customers fixed or more-stable prices for gas supplies. If in a fully-deregulated market, however, the LDCs engage in risk management activities, they (like their competitors) must assume the risk of the costs and losses inherent in those activities, so that all gas suppliers compete on a “level playing field.”

3. *Should gas utilities be limited to specific types of risk-management instruments? If so, what types?*

The natural gas risk management market is both robust and mature with a wide variety of both standardized and individually-negotiated products, including NYMEX contracts, and over-the-counter instruments (“OTC” swaps, options, collars, floors, caps, puts, and calls). Different products have different advantages and disadvantages and can be used for different purposes.<sup>3</sup> To insure maximum effectiveness of a risk management program, LDCs implementing such programs should be given

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<sup>3</sup> There are advantages and disadvantages to both the NYMEX and OTC contracts. For NYMEX, the advantages are standardized terms, reduced credit risk, short-term liquidity, and price transparency, while the disadvantages are contractual rigidity, daily margin calls and administrative costs. Advantages of OTC products include customized terms and long-dated liquidity, with the disadvantages being credit risk, less ease of execution, and less price-transparency.

latitude to use the most appropriate product to achieve the program objective. Thus, DETM would not propose that LDCs be limited to the use of a particular type of risk management product. Instead, to the extent the Department seeks to impose safeguards on the operation of a risk management program, it should do so through the establishment of other limits, such as (i) limits on the terms of such programs,<sup>4</sup> (ii) the maximum dollar exposure under such programs, or (iii) the percent of the LDC's gas portfolio that can be hedged.

4. *Should there be a percentage volume of gas that LDCs would be allowed to hedge?*

DETM's response to this question is similar to its views in response to Question Number 3, in that the degree or scope of permitted risk management activities should be dependent on the experience of the Department and LDCs participating in such programs. As a preliminary step, the Department might consider restricting risk management programs to specific volumes or percentages of the LDCs' portfolios; however, DETM would support any reasonable level determined by the Department or self-imposed by the LDCs. See also, DETM's response to Question Number 9.

5. *What should the core objectives of a hedging program be (e.g., least cost, price stability)?*

As noted above, hedging does not result in the lowest possible gas price. Therefore, the core objective of any risk-management program should **not** be to guarantee the lowest possible costs. Instead, the primary objective of any Department approved risk management program should be price stability and price certainty. When appropriately implemented, such programs should have the additional benefit of permitting LDCs to avoid the short-term price spikes that can be harmful to both the financial health of the utility and its customers.

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<sup>4</sup> If the Department is inclined to authorize a pilot program for the LDCs to engage in certain hedging activities, DETM would support such a program provided that it is long enough to provide the stakeholders with a fair test of hedging. In this regard, DETM suggests that the minimum time for any such pilot program be two years.

6. *How will the Department assess risk-management programs? What benchmarks should be used to measure a risk-management program's performance?*

Because risk management programs should not be designed to produce the lowest possible gas costs but instead to provide consumers with price certainty and stability, for LDCs subject to traditional utility regulation, such programs should be evaluated solely on the basis of whether the LDCs have complied with any parameters prescribed by the Department for the conduct of such programs. Specifically, LDCs should not be exposed to the risk of underrecovery of the costs associated with the implementation of risk management programs solely because the hedged costs occasionally exceed market prices, because that will be inevitable. Instead, at the outset of the program the Department should establish the precise parameters within which LDCs are to conduct their risk management activities and evaluate their performance solely against those parameters.

In a fully-deregulated retail market, of course, there should be no after-the-fact assessment of the LDCs' risk management activities. If the LDC is simply one gas supplier among many competitors, then the LDC's use of hedging should not be singled out for review and/or recovery any differently from the LDC's other gas supply procurement costs. Basically, the LDC's gas supply costs should be judged on the same basis as those of other gas providers, which is through the marketplace. In other words, if customers value the LDC's gas supply procurement efforts more than other competitors, then customers will sign up with the LDC as their gas supplier.

7. *What standard of review should the Department apply to the utilities' initial risk-management program?*

See DETM's response to Question Number 6.

8. *What types of costs are associated with risk-management? Should LDC/s be allowed to recover these costs? If so, please explain how.*

With respect to LDC cost recovery of the costs of hedging, please see DETM's response to Question Number 6.



Concerning the costs associated with the use of risk-management techniques, DETM's experience is that there can be substantial costs and losses (relative to market prices) associated with the implementation of an effective risk management program. Some of the direct costs include the costs of purchasing and collateralizing a risk management product. Indirect costs include access to varying types of informational services, computer hardware and software, the ability to use financial resources, personnel training and employment of experienced personnel, supervision by experienced personnel, and accounting services.

For a number of years, DETM has actively used risk management products as part of providing energy services to customers throughout North America and has established the necessary system platform and personnel base to conduct risk management activities. By trading on a nationwide basis, including the use of risk management techniques, DETM has been able to mitigate the risk that any one trade or group of trades will seriously damage the financial well being of the company. One of the benefits of permitting LDCs to use established marketers like DETM to provide risk management services on their behalf is the avoidance of the potentially significant costs associated with establishing an effective risk management program from scratch while obtaining the benefits of the established marketer's experience and systems. It is for this reason that DETM suggests that the Department seriously consider permitting any LDC who decides to engage in hedging to retain an experienced gas trader/buyer to help manage these transactions.

9. *Should an incentive mechanism be used in conjunction with a risk-management program? If so, please explain how this mechanism should be structured?*

As noted in response to Question Number 6, the answer depends on whether the LDC is functioning in a fully-deregulated retail market or, as here, as a regulated utility. In the latter circumstance, DETM believes the LDC should have an incentive mechanism built into its participation in a risk management program in order to encourage such participation. Certainly if the LDC

wants/needs to engage the help of an experienced gas trader/buyer in this process, a system of incentives would help pay for that service.

As to what type(s) of incentives would be warranted, DETM suggests one approach would be to permit LDCs to retain some percentage of the gains resulting from the implementation of such programs.

### **CONCLUSION**

Risk-management or hedging practices have been a valuable tool in building and sustaining DETM's nationwide energy service businesses and can provide important benefits to consumers in the form of price certainty, price stability and the avoidance or minimization of short-term price spikes. For that reason, DETM encourages the Department to permit LDCs to implement carefully-designed risk management programs and to seek assistance from those like DETM who have both experience and a measure of success in establishing such programs.

Respectfully submitted,

Gordon J. Smith, Esq.  
JOHN & HENGERER  
1200 17<sup>th</sup> Street, NW  
Suite 600  
Washington, DC 20036  
(202) 429-8814  
gsmith@jhenergy.com

Counsel for Duke Energy Trading and  
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